DEPARTMENT OF STATE REVENUE

LETTER OF FINDINGS NUMBER: 06-0238
Sales and Use Tax
For Tax Years 2002-04

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ISSUE

I. Sales and Use Tax—Manufacturing

Authority: IC § 6-2.5-1-5; IC § 6-2.5-2-1; IC § 6-2.5-5-3; IC § 6-2.5-5-8; IC § 6-2.5-13-1; IC § 6-8.1-5-1; 45 IAC 2.2-4-3; 45 IAC 2.2-4-12; 45 IAC 2.2-4-13; 45 IAC 2.2-5-8; Commissioner's Directive 23

Taxpayer protests the assessment of sales and use tax.

II. Tax Administration—Negligence Penalty

Authority: IC § 6-8.1-10-2.1; 45 IAC 15-11-2

Taxpayer protests the imposition of a ten percent negligence penalty.

STATEMENT OF FACTS

Taxpayer is a manufacturer with operations in several states, including Indiana. As the result of an audit, the Indiana Department of Revenue ("Department") issued proposed assessments for sales and use tax. Taxpayer protests a portion of these assessments. Further facts will be supplied as required.

I. Sales and Use Tax—Manufacturing

DISCUSSION

Taxpayer protests the imposition of sales and use tax for the years 2002 through 2004. The Department used a sample and projection method for taxpayer's purchases. The projection did not include electrical usage, which was determined separately. Taxpayer disagrees with some of

the assessments. As provided in IC § 6-8.1-5-1(b), the burden of proving a proposed assessment wrong rests with the taxpayer.

First, taxpayer protests the imposition of sales tax on three items which the Department determined did not qualify for the manufacturing exemption. The three items are uncoilers, wrapping machines, and a slitter line. The manufacturing exemption is provided by IC § 6-2.5-5-3, which states:

> (a) For purposes of this section:
> (1) the retreading of tires shall be treated as the processing of tangible personal property; and
> (2) commercial printing shall be treated as the production and manufacture of tangible personal property.
> (b) Transactions involving manufacturing machinery, tools, and equipment are exempt from the state gross retail tax if the person acquiring that property acquires it for direct use in the direct production, manufacture, fabrication, assembly, extraction, mining, processing, refining, or finishing of other tangible personal property.

Also of relevance is 45 IAC 2.2-5-8, which states in part:

> (a) In general, all purchases of tangible personal property by persons engaged in the direct production, manufacture, fabrication, assembly, or finishing of tangible personal property are taxable. The exemption provided in this regulation [45 IAC 2.2] extends only to manufacturing machinery, tools, and equipment directly used by the purchaser in direct production. It does not apply to material consumed in production or to materials incorporated into tangible personal property produced.
> (b) The state gross retail tax does not apply to sales of manufacturing machinery, tools, and equipment to be directly used by the purchaser in the direct production, manufacture, fabrication, assembly, or finishing of tangible personal property.
> (c) The state gross retail tax does not apply to purchases of manufacturing machinery, tools, and equipment to be directly used by the purchaser in the production process provided that such machinery, tools, and equipment are directly used in the production process; i.e., they have an immediate effect on the article being produced. Property has an immediate effect on the article being produced if it is an essential and integral part of an integrated process which produces tangible personal property.
> …
> (d) Pre-production and post-production activities. "Direct use in the production process" begins at the point of the first operation or activity constituting part of the integrated production process and ends at the point that the production has altered the item to its completed form, including packaging, if required.
> …
> (f) Transportation equipment.
> (1) Tangible personal property used for moving raw materials to the plant prior to their entrance into the production process is taxable.

(2) Tangible personal property used for moving finished goods from the plant after manufacture is subject to tax.
(3) Transportation equipment used to transport work-in-process or semi-finished materials to or from storage is not subject to tax if the transportation is within the production process.
(4) Transportation equipment used to transport work-in-process, semi-finished, or finished goods between plants is taxable, if the plants are not part of the same integrated production process.
…
(g) "Have an immediate effect upon the article being produced": Machinery, tools, and equipment which are used during the production process and which have an immediate effect upon the article being produced are exempt from tax. Component parts of a unit of machinery or equipment, which unit has an immediate effect on the article being produced, are exempt if such components are an integral part of such manufacturing unit. The fact that particular property may be considered essential to the conduct of the business of manufacturing because its use is required either by law or by practical necessity does not itself mean that the property "has an immediate effect upon the article being produced". Instead, in addition to being essential for one of the above reasons, the property must also be an integral part of an integrated process which produces tangible personal property.
…
(k) "Direct production, manufacture, fabrication, assembly, or finishing of tangible personal property" is performance as a business of an integrated series of operations which places tangible personal property in a form, composition, or character different from that in which it was acquired. The change in form, composition, or character must be a substantial change, and it must result in a transformation of property into a different product having a distinctive name, character, and use. Operations such as compounding, fabricating, or assembling are illustrative of the types of operations which may qualify under this definition.
(l) Energy equipment.
(1) Equipment used to modify energy purchased from public utilities purchased for the production process is exempt if the equipment is used to modify the utilities for use by exempt equipment.
(2) Equipment used to create energy that could otherwise be purchased exempt from a public utility for use by exempt equipment is exempt.
(3) When any equipment qualifies as essential and integral to the production process and also is used in an alternative nonessential and/or non-integral manner, the exemption shall only apply to the percentage of use of the equipment used in the exempt manner.

Taxpayer believes that the three items qualify for this exemption. Taxpayer has not provided documentation in support of its protest on these items. However, taxpayer did provide sufficient explanation, which matches the audit's description, of the slitter's operation to establish that it qualifies for the production exemption. However, as explained by 45 IAC 2.2-5-8(g):

> Machinery, tools, and equipment which are used during the production process and which have an immediate effect upon the article being produced are exempt from tax. Component parts of a unit of machinery or equipment, which unit has an immediate effect on the article being produced, are exempt if such components are an integral part of such manufacturing unit. *The fact that particular property may be considered essential to the conduct of the business of manufacturing because its use is required either by law or by practical necessity does not itself mean that the property "has an immediate effect upon the article being produced"*.
> …
> (emphasis added)

There is insufficient analysis and documentation to support taxpayer's position that the production exemption applies to the uncoilers and wrapping machines. Examination of the documentation available indicates that the uncoilers may be essential, but do not have an immediate effect upon the article being produced. There is insufficient explanation and documentation to establish that the wrapping machines qualify for the exemption found at 45 IAC 2.2-5-8(d).

Next, taxpayer protests the Department's adjustment to the taxation of taxpayer's purchase of electricity. Taxpayer believes that it is entitled to the "predominant use" exemption found in 45 IAC 2.2-4-13(e), which states:

> Where public utility services are sold from a single meter and the services or commodities are utilized for both exempt and nonexempt uses, the entire gross receipts will be subject to tax unless the services or commodities are used predominantly for excepted purposes. Predominant use shall mean that more than fifty percent (50[percent]) of the utility services and commodities are consumed for excepted uses.

The Department determined that taxpayer did not meet the fifty percent threshold necessary to qualify for this exemption. The Department did not impose tax on the remaining percentage of taxpayer's exempt use of electricity as provided in 45 IAC 2.2-4-12. Taxpayer protests that the Department did not use the correct method for determining exempt use and that it should be eligible for the predominant use exemption. Taxpayer did not provide any explanation of its preferred method or documentation to establish that its method is superior to the Department's. However, since it has already been determined that the slitters are production equipment, and since part of the Department's reason for determining that taxpayer's electrical usage was less than fifty percent for production was that the slitter was reclassified as non-production, the percentage will need to be adjusted. A supplemental audit will determine if the inclusion of the slitter in production equipment will result in taxpayer's usage rising above the fifty percent threshold for purposes of 45 IAC 2.2-4-13(e).

Next, taxpayer protests the imposition of tax on "journal entries" which it states are not original documents. Taxpayer believes that the journal entries clearly marked reclassifications and adjustments are included in the audit's report of errors and potentially duplicate amounts already

included on actual invoices. Taxpayer states that a simple journal entry is not a retail transaction and is not subject to the sales and complimentary use tax. Taxpayer has not provided sufficient documentation to establish that there is any duplication in the audit projection.

Next, taxpayer protests the imposition of tax on shipping charges prior to January 1, 2004. Taxpayer states that Commissioner's Directive 23 establishes that shipping charges were not subject to sales tax prior to January 1, 2004. A review of Commissioner's Directive 23 shows that the changes made to IC § 6-2.5-1-5 did not establish that delivery charges were subject to sales tax, but rather confirmed that delivery charges were subject to sales tax. Further confirmation is found at 45 IAC 2.2-4-3, which explains:

> (a) Separately stated delivery charges are considered part of selling at retail and subject to sales and use tax if the delivery is made by or on behalf of the seller of property not owned by the buyer.
> (b) The following guidelines have been developed:
> (1) Delivery charge separately stated with F.O.B. destination–taxable.
> (2) Delivery charge separately stated with F.O.B. origin–non taxable.
> (3) Delivery charge separately stated where no F.O.B. has been established–non taxable.
> (4) Delivery charges included in the purchase price are taxable.
> (c) Two considerations must always be kept in mind in applying these guidelines:
> (1) The rules do not override established interstate commerce exemptions recognized by IC 6-2.1-3-3 (see 6-2.5-5-24(b)(010) [45 IAC 2.2-5-54]).
> (2) The rules are only applicable in determining whether or not the delivery charge of an otherwise taxable sale is also subject to sales or use tax.

This version of 45 IAC 2.2-4-3 has been a regulation since 1987. Shipping charges were always subject to sales tax. Commissioner's Directive 23 simply explained the modification of some of the language in IC § 6-2.5-1-5. Taxpayer's argument that shipping charges only became taxable on January 1, 2004, is incorrect.

Next, taxpayer protests that the Department included leases of transportation equipment sitused outside of Indiana. Taxpayer refers generally to IC § 6-2.5-13-1. Of relevance is IC § 6-2.5-13-1(f), which states:

> The lease or rental of motor vehicles, trailers, semitrailers, or aircraft that do not qualify as transportation equipment, as defined in subsection (g), shall be sourced as follows:
> (1) For a lease or rental that requires recurring periodic payments, each periodic payment is sourced to the primary property location. The primary property location shall be as indicated by an address for the property provided by the lessee that is available to the lessor from its records maintained in the ordinary course of business, when use of this address does not constitute bad faith. This location shall not be altered by intermittent use at different locations.

> (2) For a lease or rental that does not require recurring periodic payments, the payment is sourced the same as a retail sale in accordance with the provisions of subsection (d).
> This subsection does not affect the imposition or computation of sales or use tax on leases or rentals based on a lump sum or accelerated basis, or on the acquisition of property for lease.

Since it is not clear if the lease of the trucks require recurring periodic payments, under IC § 6-2.5-13-1(f)(2), it is important to examine IC § 6-2.5-13-1(d), which states:

> The retail sale, excluding lease or rental, of a product shall be sourced as follows:
> (1) When the product is received by the purchaser at a business location of the seller, the sale is sourced to that business location.
> (2) When the product is not received by the purchaser at a business location of the seller, the sale is sourced to the location where receipt by the purchaser (or the purchaser's donee, designated as such by the purchaser) occurs, including the location indicated by instructions for delivery to the purchaser (or donee), known to the seller.
> (3) When subdivisions (1) and (2) do not apply, the sale is sourced to the location indicated by an address for the purchaser that is available from the business records of the seller that are maintained in the ordinary course of the seller's business when use of this address does not constitute bad faith.
> (4) When subdivisions (1), (2), and (3) do not apply, the sale is sourced to the location indicated by an address for the purchaser obtained during the consummation of the sale, including the address of a purchaser's payment instrument, if no other address is available, when use of this address does not constitute bad faith.
> (5) When none of the previous rules of subdivision (1), (2), (3), or (4) apply, including the circumstance in which the seller is without sufficient information to apply the previous rules, then the location will be determined by the address from which tangible personal property was shipped, from which the digital good or the computer software delivered electronically was first available for transmission by the seller, or from which the service was provided (disregarding for these purposes any location that merely provided the digital transfer of the product sold).

Also, IC § 6-2.5-13-1(g) states:

> The retail sale, including lease or rental, of transportation equipment shall be sourced the same as a retail sale in accordance with the provisions of subsection (d), notwithstanding the exclusion of lease or rental in subsection (d). As used in this subsection, "transportation equipment" means any of the following:
> (1) Locomotives and railcars that are used for the carriage of persons or property in interstate commerce.
> (2) Trucks and truck-tractors with a gross vehicle weight rating (GVWR) of ten thousand one (10,001) pounds or greater, trailers, semitrailers, or passenger

buses that are:

(A) registered through the International Registration Plan; and

(B) operated under authority of a carrier authorized and certificated by the U.S. Department of Transportation or another federal authority to engage in the carriage of persons or property in interstate commerce.

(3) Aircraft that are operated by air carriers authorized and certificated by the U.S. Department of Transportation or another federal or a foreign authority to engage in the carriage of persons or property in interstate or foreign commerce.

(4) Containers designed for use on and component parts attached or secured on the items set forth in subdivisions (1) through (3).

Again, the available documentation does not make it clear which subsection covers the trucks at issue. However, since the provisions of IC § 6-2.5-13-1(d) control both situations, and since taxpayer has provided invoices showing that some of the trucks were leased from the lessor's location in another state, those leases should be sitused in the other state. Since IC § 6-2.5-2-1 imposes sales tax on all retail transactions made in Indiana, and since the truck leases at issue are sitused to the other state, those leases are not subject to Indiana sales tax.

Next, during the hearing, taxpayer protested that a prior audit had determined that its forklifts were used more than fifty percent of the time for production uses and were therefore wholly exempt. Taxpayer protested that it relied on the prior audit for this audit period. Taxpayer did not provide a written analysis or documentation to contradict the audit report in the instant case. While it has not been established that the prior audit did rule that the forklifts were used more than fifty percent of the time for production uses, it is entirely reasonable for this audit to determine that they were not used more than fifty percent of the time for production uses. Taxpayer has provided no reason or support to establish that the Department erred.

In conclusion, the burden of proving an assessment wrong rests with the taxpayer. Taxpayer has provided sufficient explanation to establish that the slitter is directly used in direct production and is therefore exempt under IC § 6-2.5-5-3(b). There is insufficient documentation and explanation to support taxpayer's claim that the uncoilers and wrappers are exempt. A supplemental audit will be required to determine if the additional electrical use on the slitter, which is now considered production, increases taxpayer's electrical usage to exceed the fifty percent threshold for the predominant use exemption. There is insufficient documentation and explanation to determine if there are duplications due to "journal entries" as claimed by taxpayer. Shipping charges have always been considered taxable and that status was not changed by the circumstances leading to Commissioner's Directive 23. Those trucks leased from a location outside Indiana should be sitused to those locations. There is no evidence to support taxpayer's protest concerning the forklifts.

FINDING

Taxpayer's protest is sustained in part and denied in part.

II. Tax Administration—Negligence Penalty

DISCUSSION

The Department issued proposed assessments and the ten percent negligence penalty for the tax year in question. Taxpayer protests the imposition of penalty. The Department refers to IC 6-8.1-10-2.1(a), which states in relevant part:

> If a person:
> …
> (3) incurs, upon examination by the department, a deficiency that is due to negligence;
> …
> the person is subject to a penalty.

The Department refers to 45 IAC 15-11-2(b), which states:

> Negligence, on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Further, failure to read and follow instructions provided by the department is treated as negligence. Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer.

45 IAC 15-11-2(c) provides in pertinent part:

> The department shall waive the negligence penalty imposed under IC 6-8.1-10-1 if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust, or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section.

In this case, taxpayer incurred a deficiency which the Department determined was due to negligence under 45 IAC 15-11-2(b), and so was subject to a penalty under IC 6-8.1-10-2.1(a). While taxpayer was partially sustained in Issue I, taxpayer was partially denied in Issue I. Therefore, taxpayer has not affirmatively established that his failure to pay the remaining deficiency was due to reasonable cause and not due to negligence, as required by 45 IAC 15-11-2(c).

FINDING

Taxpayer's protest is denied.

WL/BK/DK January 21, 2007